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From reading the newspapers, you would surmise that both parties acknowledge the problems with this deficit and wish to reduce it. The debate is over how to do that. Democrats would prefer to raise taxes. The Republican solution is to keep the growth of spending below the growth in the economy. This would eliminate the deficit over time without any tax increases and without actually reducing spending. You may think that this is just a philosophical difference, but it is more. One of these solutions will work; the other will not.

Conventional wisdom is that raising taxes increases government revenue. However, sound economics and recent experience prove this is not always the case. The so-called “Bush tax cuts” were passed by Congress and signed by the president in 2003. The first year after the tax cuts, total revenue to the federal government increased by about 6%. In the second year after the tax cuts, revenue increased by 15% and this year even the most conservative projections estimate another increase of about 7%. That is an average revenue growth of almost 10% a year in the three years following a major reduction in tax rates.

Now, let’s look at the well-remembered 1990 tax increase that contributed to the reelection defeat of the first George Bush. In the three years following that tax hike, revenues increased by an average of 3.9%. President Clinton raised taxes again at the beginning of his first term as president. In the full eight years of the Clinton presidency, revenues increased by a yearly average of less than 3.7%.

Over the past 15 years, tax reductions resulted in revenue increases that are more than double the revenue increases that followed tax hikes. Why does this happen, and why are the friends of more taxes able to convince people otherwise?

When taxes go up or down, taxpayers adjust their behavior. Taxpayers, for example, are more likely to sell an underperforming asset and incur a capital gain when the tax is lower because the economics of reinvesting are better. Similarly, if the rate goes up, that same taxpayer may choose to keep the asset, thus not paying taxes on any gain, because they can't achieve a better return after the increased tax bite. So, the lower tax generates more actual revenue to the government.

Add to this the general economic effect of the reallocation of that capital to a more efficient use. The reallocated capital generates other additional income on which taxes are paid. In short, the lower rate stimulates economic growth which creates more revenue for the government even at the lower rate.

Using the estimated behavior adjustments caused by tax increases or decreases to calculate their effect on revenue is known as dynamic scoring. The reason that the tax raisers stick by their failed philosophy is because they use only static modeling. Under static modeling, analysts assume no one will change any behavior when a tax goes up (or down). And they assume that there is no economic impact. So of course, under this method of projection, any tax increase will automatically raise revenue by the exact amount of the increase.

Businesses use dynamic modeling. If they used static modeling, then every business in the country should raise their prices right now. Static modeling would assume no change in behavior, so any increase in prices will not affect sales or volume. Therefore, a price increase will always equate to more profit. That is obviously not true. People buy less of something that is more expensive. But in Washington, truth and accuracy are often eclipsed by political forces pushing to advance an agenda that cannot withstand scrutiny.

So, what does all this mean and what should we do now that we know this? First of all, make the 2003 tax cuts permanent (they are scheduled to expire in 2008) and pass further cuts, such as the elimination of the death tax which will also generate more revenue.

Second, use dynamic modeling in Washington. Congressman Jeff Flake (R-AZ) has a bill, HR 2842 - which I have co-sponsored, to do just that.

Third, recognize that our deficit has been caused by too much spending, not by tax cuts. Our deficit has remained about the same over the last three years, but revenues have risen by 29%. This is because spending has risen by over 8% a year. We will never tax our way out of this deficit. It’s all about the spending. We must reduce the growth rate of spending and keep the economy growing through lower tax rates so that revenues increase faster than spending.